

ECJ decision facilitates financing: interest-free “loan” from the tax office!

by

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A decision of the European Court of Justice (-ECJ-) of 21 April 2005, which ties in with the ECJ ruling in the “Seeling” case on turnover tax/ input tax, may considerably facilitate the financing of private building projects by married couples. The ECJ decision, which is also binding for German tax authorities and tax courts, enables taxpayers to deduct the entire input tax on real estate that has mainly been built/ used for private purposes (e.g. marital homes). The prerequisite, however, is that, apart from being privately used, the residential building is also used for at least 10% business purposes. The Federal Ministry of Finance (- FMF -) has meanwhile published several information brochures on this subject area.

With private building projects, the building principal cannot claim deduction for turnover tax paid, which is shown on the invoices issued by construction companies, as input tax towards the tax office.

If the building principal intended to use the real estate partly for both private and business purposes (mixed use, as it is termed), the tax offices hitherto allowed only proportional deduction of input tax for the part of the real estate that was used for business purposes. The ECJ has now basically lifted this restriction with its decision of 21 April 2005 in the case C-25/03. It found that the entire real estate is used for business purposes if a “home office” has been set up for one of the spouses in the family flat/ house. It is particularly noteworthy that the ECJ points out that it doesn’t matter with residential buildings jointly built by both spouses who of the spouses has been invoiced – the input tax is deductible at any rate.

The effects of the ECJ decisions are to be illustrated by the following example:

Married couple E wants to build a house. Wife F owns a building plot. Together with her husband M, she builds a villa with 650 square metres of total living space on it. The construction costs amount to EUR 3 million (gross); the turnover tax incurred (16%) is about EUR 414,000.00. In the basement they set up an office taking up 130 square metres (20% of the total living space). The office space is rented out to a GmbH (limited liability company) for EUR 1,700.00 EUR/ month plus 16% turnover tax for 10 years (with option of renewal). The managing director of the GmbH is the husband; the office space is used as archives and as a “second” office of the managing director. The villa is thus used for 20% business purposes and 80% private purposes. The overheads and maintenance costs (electricity, repair, etc.) amount to EUR 10,000.00 a year plus 16% turnover tax (EUR 1,600.00).

The villa was jointly built by the spouses and jointly rented out to the GmbH. The spouses are thus an entrepreneur as defined by the Turnover Tax Act. As the villa is used for more than 10% business purposes, the spouses can reclaim the full input tax on all construction costs; the spouses will thus be refunded **EUR 414,000.00** by the tax office. Furthermore, the entire input tax on maintenance costs can be deducted. For clarification, the spouses should set out in writing to the tax office that they consider the villa a part of their rental business. The spouses have to pay 16% turnover tax on rental income to the tax office; however, the GmbH for its part can deduct it as input tax.

However, as the spouses use the villa for 80% private purposes, this use must be considered with regard to turnover tax as personal use by the taxpayer. This personal use is calculated from the portion of costs (including depreciation) spent on the villa. The personal use by the taxpayer for 2005 is thus calculated as follows:

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|---|-----|-------------------------|
| Depreciation (10% on net construction costs): | EUR | 300,000.00 |
| Maintenance costs (net): | EUR | <u>10,000.00</u> |
| Total | EUR | 310,000.00 |
| *80% (share of private use) | EUR | 248,000.00 |
| 16% turnover tax = | EUR | <u>39,680.00</u> |

It becomes clear that the 10% depreciation on net construction costs results in a relatively high proportion of personal use. The 10% depreciation is based on a special FMF order; normally it would only be 2% p.a. (!). Many experts therefore challenge the legality of the FMF order. Relevant actions are already pending before the Federal Fiscal Court and might also be referred to the ECJ as the final court of appeal.

A change in the use of office space (extension or reduction to 10%) does not lead to a change in the input tax already deducted on production or maintenance costs. Only the calculation of the personal use will change.

The 10% depreciation, however, shows that the granting of full input tax deduction is only a temporary advantage. The advantage will mainly be eliminated after ten years – if the depreciation rate is lawful. Nevertheless, there are considerable liquidity and financing advantages especially at the stage of the building's erection.

Building principals, however, should pay attention to the VAT rate. The calculations are always to be based on the current tax rate. The planned increase in VAT to 19% in 2007 must thus be taken into account.

Furthermore, it has to be borne in mind that the fiscal authorities qualify the final non-business use, that means the termination of the business use of the building or of a part of the building, as a withdrawal, as it is called. This withdrawal must be subject to turnover tax. However, some doubt whether this view taken by the fiscal authorities is lawful. The basis of taxation is the market value of the real estate. Thus, the entire input tax credits are not only reversed, but taxation is also based on a value which will considerably exceed the historical production costs because of customary appreciation. If the business use is to be terminated, one possible solution would be to sell the real estate since gains derived from the sale are still tax-exempt in accordance with the provisions of the Turnover Tax Act (§ 4 Nr. 9a UStG).

It might particularly be a good idea to sell the real estate or the co-ownership share in the real estate to the other spouse – accompanied by a cancellation of the office space lease at the same time. In order to pursue this course, it might, however, be advisable that the building be built by one spouse only to enable a legally correct transfer of the real estate to the other spouse. Another possibility would be to transfer the real estate from or to other legal entities/companies. This, however, depends on whether and which long-term plans the spouses pursue regarding their property, for example regarding an anticipated succession.

Although some points still need final clarification, the model presented is an alternative or addition worth considering to the conventional forms of financing with private house building. For further details regarding methods of financing opened up through this new ECJ decision, please contact a certified attorney at tax law.